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SUBJECT: UKRAINIAN NATIONAL BANK IMPOSES CAPITAL CONTROLS

REF: A) KYIV 2028, B) KYIV 1995, C) KYIV 1959

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¶1. (U) Summary. The National Bank of Ukraine (NBU), pressed to stop a run on deposits in commercial banks, sharply tightened capital controls on October 13. The measures effectively prevent Ukraine's banking system, which has relied heavily on foreign borrowing to fuel its breakneck growth in recent years, from expanding any further in the short term. The action comes after an estimated $3 billion, or 4% of total deposits, were withdrawn from the banking system over the past two weeks. The October 13 measures are the first taken by the NBU to preempt capital flight and stabilize the country's teetering financial system. Coming just prior to an International Monetary Fund (IMF) delegation to Ukraine, the NBU's heavy-handed measures may prevent a meltdown in the very short run, but they could have a severe impact on economic growth in the medium term if not modified or replaced by more flexible measures. End Summary.

¶2. (U) The NBU's Resolution 319 introduces a wide range of restrictions on the financial system that will effectively prevent banks from expanding in the short run. Banks may only extend a new loan when an existing loan is paid back, and they cannot expand their loan portfolios beyond their October 13 positions. Banks are also forbidden from releasing deposits earlier than the maturity agreed upon when the deposit was received. In addition, banks may not sell foreign currency to purchase imports without proof that the imported goods or services have been delivered in Ukraine, with few exceptions. In order to reduce the recent wild swings in the UAH exchange rate, the NBU introduced measures aimed at limiting the spreads between the buy and sell exchange rates quoted by banks to five percent. Such "bid-ask spreads" had recently widened dramatically in tandem with the mounting insecurity over the hryvnia (Ref A and B).

¶3. (SBU) The harsh NBU measures, according to national bankers and politicians, were designed to boost confidence in Ukraine's overall financial system. First Deputy NBU Governor Anatoliy Shapovalov pointed to the need to calm fears, since "panics are 90 percent the result of psychological triggers." NBU Governor Volodymyr Stelmakh and Finance Minister Viktor Pynzenyk had conducted an emergency meeting with Ukrainian President Viktor Yushchenko to discuss possible steps and receive blessing for NBU actions. After the meeting, Yushchenko, himself a former bank governor, shied away from talk of a financial crisis. Instead, he placed blame on the "weak" budget policy of Prime Minister Timoshenko that has led to the "challenges that have emerged."

¶4. (SBU) Prices on Ukraine's small and illiquid stock market fell after the NBU's stabilization program was announced. Analysts suggested this was primarily due to the NBU's unusual limitation on early withdrawal of deposits. Mindful of the need to prevent a run

on banks, parliamentarians proposed their own alternative plan to increase deposit guarantees up to $40,000. The Rada measure has stalled, however, due to Ukraine's concurrent political crisis. The effect of Resolution 319 on banks and the equity market was immediate, with the PFTS stock index losing 5.5 percent over the course of the day. In addition, S&P lowered its ratings for three Ukrainian banks - Hadra, Alfa-Bank, and Kredobank - from "stable" to "negative," reflecting the rise of systemic risks in the financial sector.

¶5. (SBU) The International Monetary Fund has confirmed to us that a delegation will arrive in Kyiv on October 15. IMF sources say that a request was made in recent days by the GOU, but no official announcement has been released. It remains unclear whether the Ukrainians have requested a financial assistance package or so-called "exceptional access."

¶6. (SBU) Comment: The NBU's resolution, coupled with major downward pressure on the hryvnia (Ref B), are strong evidence that the spreading global financial crisis may cause a meltdown in Ukraine's financial sector, which had grown rapidly in recent years on the back of foreign borrowing. Although it has targeted the capital market to prevent further panic, Resolution 319 may also stifle economic activity by restricting credit for investment and debt repayment. The undifferentiated, across the board cap on credit growth may prevent banks from financing even the most worthy of investment projects. Import markets -- even for investment goods needed to expand the economy -- are reportedly coming to a standstill, because banks cannot extend hard currency for payment until goods are imported. The NBU gave no indication how long the new regulations will remain in force, but the rules will no doubt need to be modified or relaxed once confidence in the financial

system is restored, so as not to put a further break on Ukraine's economic growth. End Comment.

TAYLOR